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TO: Joint Economic Committee  
United States Congress

Attn: Richard Kaufman

Attached is the sanitized version of the  
JEC transcript for 21 November 1984 on China.

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According to  his branch chief, the document has  
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Senator Proxmire. Now let's get into the Chinese, if you'd like to present your presentation there.

Mr. Gates. All right, sir.

Much of what has happened economically in China over the past year-and-a-half reflects the successes and failures of Beijing's massive experiment with economic reform. The experiment, which has been underway since 1978, has touched virtually every sector of the economy. Under what China calls its "contract responsibility system," farmers now have effective control, but not ownership, of most of the acreage in China. Peasants determine, to a large degree, what and how much they produce.

Enterprises that formerly remitted all but a small share of their profits to the state now retain a much larger share.

Moreover, for the first time in over 20 years, individual entrepreneurs have been allowed to set up small businesses, such as restaurants, barber shops, and clothing stands, and actually to employ small numbers of workers.

Economic performance in 1983-1984, particularly in agriculture, looks quite impressive, statistically. Agricultural output jumped sharply as a result of both the contract responsibility system and the better-than-ever weather conditions. Grain output reached a record 387 million tons in 1983, and may top 405 million tons this year. Cotton production jumped 25 percent last year, to a record 4-1/2 million tons. And

another rise, perhaps as much as 10 or 15 percent, may be in the offing this year.

The energy sector provided Chinese policymakers with what was perhaps their most pleasant economic surprise of 1983-1984, as primary energy output rose at about a 6-percent clip, the fastest pace in five years.

Oil production rose to 106 million tons in 1983, enabling China to export 15 million tons of crude, and output should hit a new record of 114 million tons by the end of this year.

Coal output topped 700 million tons last year, and probably will reach 760 million this year.

China's international financial picture also improved steadily over the past 18 months. International reserves now stand at more than \$20 billion, the tenth largest worldwide, and China will run a fourth consecutive large trade surplus in 1984. Beijing has borrowed very little over the past two years, and much of what it acquired came in the form of government-subsidized loans or money from international financial institutions at low interest rates. As a result, less than 6 percent of export earnings are required to service China's foreign debt.

The military has been asked to sacrifice somewhat for the time being in order to help revive China's economy. Chinese budget statistics show defense outlays as a share of government spending falling moderately, from 17-1/2 percent in 1979, during

the border war with Vietnam, to 15.3 percent in 1982, and 13.7 percent last year.

Although data for 1984 are still unavailable, we believe the military expenditure figure remained at 13-14 percent of government spending.

The PRC figures probably underestimate total defense spending, but we believe they accurately reflect the recent trends. The military has so far accepted the need for sacrifice, with the understanding that as the economy improves the armed forces will be appropriately rewarded.

The statistics on industrial performance also appear quite respectable. Industrial production rose at an annual rate of about 11 percent over the past 18 months.

Senator Proxmire. Can I interrupt to ask: You have just read that military expenditures may have slipped below 15 percent of government spending by now.

Mr. Gates. Yes, sir.

Senator Proxmire. Can you give us a percentage of GNP?

Mr. [redacted] We haven't done the same kind of costing things STAT that our colleagues covering the Soviet Union have done. But we do have a GNP figure worked out in dollars, and I could sit down and crank a rough estimate out for you. The hesitations that the Soviet analysts have in doing this kind of thing are even more amplified in our group.

Senator Proxmire. Can you give us a ballpark figure? Would this be 10 percent of GNP, or 12, or eight?

Mr. [redacted] I will provide that information for the record. STAT

Senator Proxmire. All right.

(INFORMATION TO BE FURNISHED.)

RESPONSES TO QUESTIONS FROM PROXMIRE HEARINGS

CHINA SECTION

[redacted] STAT

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**THE DEFENSE BURDEN**

Beijing claims that it spent 17.7 billion yuan (about \$9 billion) on defense in 1983. We calculate that China's GNP for that year was about \$275 billion which yields a defense burden of only about 3.3 percent. CIA's military experts believe that the Chinese figure for military spending may underestimate actual expenditure levels by as much as 50 percent. Assuming this to be the case, the actual defense burden is probably closer to 7 percent of China's GNP.

Mr. Gates. An equally impressive performance has been achieved in their production of such consumer items as refrigerators, washing machines, fans, and TVs. Beijing has experienced some inflation, but at manageable levels of 5 to 8 percent.

In short, we estimate that China's real GNP grew about 8 percent last year, and even sharper growth of 9 to 11 percent can be expected this year.

Despite the impressive statistics, Chinese leaders have become increasingly dissatisfied with the industrial sector. When reforms were first introduced in 1978, it was not industrial growth that the government was interested in. In fact, Beijing said it would willingly sacrifice short-run growth if, through reform, it could make its enterprises more efficient.

In this area, China has failed. Its domestic enterprises continue to be among the world's most inefficient, using, by some estimates, up to 3-1/2 times more energy to produce a unit of output than the average less-developed country firm.

At the same time, energy shortages presently idle 20 percent of China's industrial capacity. Raw material consumption is also high, and has shown almost no sign of coming down.

The state calls for reductions in per-unit consumption of raw materials, have been answered instead by increases. Then, too, the quality of China's output remains very low. And labor

and capital productivity have failed to improve under initial reform efforts.

Finally, when China released its grip on the industrial decisionmaking process, it also gave up some of the control it once had over macroeconomic activity. In the wake of that move, China has been forced to accept five consecutive budget deficits totalling more than 55 billion yuan, about \$25 billion.

Runaway local investment drained both capital and raw materials away from high priority infrastructure projects, and mounting price pressures showed up in budding black markets, speculative activity, and rising free market prices. For a while, the problems associated with the early reforms threatened to overshadow the agricultural gains. In the 1981 to 1983 period, China's Communist Party strenuously debated the question of reform. The argument revolved around whether to move rapidly ahead with new reform measures or to cut back on market-orientated practices in favor of tighter controls and more reliance on comprehensive state plans.

Earlier this year, however, Party advocates of reform moved into a predominant position. As a result, the drive to restructure the economy has accelerated.

At the same time, the emphasis has shifted away from agriculture, where the results have been good, to industry, where little real progress has been made. By late June, Chinese economists publicly were calling for experiments with such

market-oriented practices as forcing state banks to compete against each other, allowing enterprises to issue stock and bonds, and were even advocating reform of the price system. Such proposals would have been labeled heretical five years ago.

In early October, the state council issued provisional regulations on improving the planning system -- a detailed document calling for, among other things, a major overhaul of China's complex planning bureaucracy. The meeting of the Third Plenary Session of the 12 Central Committee on the 20th of October firmly committed the Party to economic reform.

The Plenum approved a document on the reform of economic structure that reiterated all the elements of earlier reform efforts, and went further than any previous document on important questions such as price reform. In essence, the Party committed itself to a comprehensive restructuring of its economic apparatus, that, if fully implemented, will permit free market regulation in China to a much greater degree than elsewhere in the socialist world, with the possible exception of Hungary.

Why is the Party now prepared to make such a massive assault on its urban economic problems?

First, the waste and inefficiency that characterized the industrial sector has reached intolerable proportions. Heavy industrial sector warehouses now store more than \$10 billion in unusable machinery, while Chinese factories continue to produce mostly 1950 and 1960 vintage equipment. Chinese mills continue

to produce large quantities of low quality steel but most industries complain of major shortages.

Then, too, the weakness of the urban economy began impacting on the agricultural sector. A huge surplus of grain is presently accumulating in the countryside because the urban commercial system is incapable of transporting it to points of need. At the same time, consumer goods are not reaching the countryside in quantities sufficient to meet rural demands.

Beijing also chose to move now because it believes it is well positioned economically to survive the problems that will inevitably arise from the planned overhaul. Agriculture, foreign trade, and energy are all performing well above expectations.

Finally, and perhaps most importantly, the reform wing of the Party is eager to push ahead while the 80-year-old Deng Xiaoping is still active and at the peak of his power.

Because this accelerated drive at industrial reform is in its infancy, assessing its chance for success is difficult. We can say, however, that implementation will be very tough. Major economic problems will begin surfacing immediately as price adjustments work their way through the system.

Bureaucratic infighting is bound to increase as power is redistributed. Some Party and state officials can be expected to resist the entire program, since they would tend to lose power if the reforms succeed.

Price reform is unquestionably both the most essential and

the most troublesome element of the reforms. The Chinese economy is shortage-driven, and even rumors of price adjustment can spark panic-buying and bank runs. Many Chinese citizens remember the dislocations caused by hyperinflation in the late 1940s. They react rapidly and sometimes irrationally to announcements of upward price adjustments.

Beijing has also had a difficult task in determining what to do with the nearly 20 percent of state-run enterprises that are now losing money. Factory close-downs on such a large scale would mean unacceptable unemployment problems and industrial readjustments. But to permit continued operation encourages inefficiency.

Financial problems also will continue to plague Beijing. While China has many of the fiscal and monetary tools it needs to control the macroeconomy, it has little practical experience in their use. Given the difficulties that even industrial economies have in using these tools effectively, Beijing will probably be very tempted at the first sign of major problems to resort to what it knows best -- direct control.

Finally, political opposition will continue to threaten the reform program, and it is the most difficult factor to measure.

The mounting economic problems will provide ammunition to Party and state bureaucracies that are already resisting change. Nevertheless, we are cautiously optimistic that Beijing gradually will get a good percentage of the reforms into the

pipeline, and that the new program will achieve a measure of success.

We are struck, for example, by the straightforward, nonideological approach contained in the Plenum document. Chinese leaders are keenly aware of both the economic and political obstacles they face. By allowing five years to get the program into place, Beijing is calculating realistically the tremendous problems it will face in implementation.

Beijing's willingness to launch a frontal assault on irrational prices also bodes well for success. Western and Chinese economists alike have long viewed the irrational price system as a major stumbling block to urban reform, but until this year, Party bureaucrats viewed the potential danger of price reform as too high to warrant any major experiment.

It appears now, however, that these planners realize that piecemeal reforms in the absence of rational prices may be worse than no reforms at all. In addition, by letting individuals set up service-related businesses and handle commercial functions, Beijing has unleashed forces that could markedly increase the speed at which economic transactions take place. A more smoothly functioning economy is a likely outgrowth of such policies.

On the whole, then, we believe that the industrial reform program China has devised is workable and will accelerate economic gains, albeit at a slower pace than occurred following the early agricultural reforms. Some inflation is to be

expected, though we do not believe Beijing will experience wildly spiraling prices. For this to occur, the government would have to be willing to sustain increases in consumer demand by printing money, something this fiscally conservative government is unwilling to do. In fact, we are more concerned that Beijing's fear of inflation will cause it to overreact to initial price changes by cutting back price reforms. Such a move could stall the entire reform program.

If China is successful at getting its reform program into place, there are several important implications for the United States. In our judgment, implementation of the reforms would both broaden and deepen China's ties with the United States and the West.

The emphasis on technological innovation at the plant level, foreign capital acquisition and increased joint ventures will expand investment and trade opportunities for US and Western business.

At the same time, however, the reforms will aggravate some current problems in US-Chinese relations. It can be expected that Chinese enterprises will continue to push for greater access to Western markets, and pressure on Washington to lower trade barriers probably will increase.

Similarly, Beijing will probably press harder on technology transfer in response both to its needs for economic and military modernization and the demands of its own enterprises. It is also

likely that China will reduce its grain imports from the West, as its agricultural production continues to improve.

Beijing's success with economic reform could also prove to be a tempting example for other countries struggling with central planning. Beijing reportedly is already encouraging the North Koreans to learn from Chinese reforms and relax their tight control over the economy. As China's program proceeds, other countries, including some LDCs and even a few of the East European nations that China patterned its earlier forms after, may consider making wider use of market-oriented programs.

Having said this, I must conclude, still, on a cautious note. Several factors could derail China's reform program completely. For example, the death of China's 80-year-old leader would remove from the scene the most powerful advocate of reform. Deng's most likely successors are also deeply committed to reform, but in his absence, they probably would not be able to push the program to the extent he has done.

Other problems, such as a sharp upsurge in speculation and economic crime or several years of bad weather could, over the longer term also tip the political scales against reform and lead to retreat.

Senator Proxmire. I appreciate that.

Both these presentations have been extremely good. And as Richard Kaufman just mentioned to me, this is the kind of corrective for the feeling that there's a lot of Chinese euphoria

going on, that they're going to be the Adam Smith free enterprise economy any day now. I think the note of caution is very welcome.

In your discussion of improvements and recent successes in Chinese agriculture, you say that improved weather and price increases have played an important role together with market-oriented rural reforms.

First, weren't the price increases part of the reforms, and secondly, can you assign weights to the roles of reform and weather in recent improved performance?

[redacted] There is some question about exactly what you include under the label of reform. The people in our shop who have examined the agricultural sector most carefully choose to distinguish somewhat between price adjustments, which China has tried periodically over the past 30 years, and the recent structural changes such as introduction of the contract responsibility system. The latter changes we are calling "economic reform."

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Our experts believe that even if the commune system had been left in place, and the economic structure had remained basically as it was, increased prices would have elicited an output response. Nevertheless, the freedom that the Chinese have given the farmer to make production decisions and to carry out those decisions has undoubtedly strengthened the output response.

As to how to weight each of these factors in terms of their

impact on production, there is a great difference of opinion between experts both within our office and outside.

Weatherwise, the Chinese say that 1983 was in many ways the worst year they have had in some time. But, in terms of grain and cotton, they had the best harvest they've ever had. So there's some indication that weather, while it has played a role in this, is not playing as important a role as perhaps some people would think.

Senator Proxmire. It sounds like it might be playing a perverse role.

[redacted] In what sense?

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Senator Proxmire. In other words, if they had these bounteous crops of wheat and cotton, and they had it in spite of bad weather, it sounds as if their reforms are more responsible than they would be, if the weather had been the same.

[redacted] I'm not sure that's the case. If the weather had been better, they might have gotten additional gains beyond what they achieved. What I think we can say is that the agricultural reforms are proving capable of generating production gains even under adverse climatic conditions.

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We can start to say, sure, the weather's always been a factor, but the price adjustments, and the introduction of the contract responsibility system, are perhaps the major elements in this whole expansion we've seen in ag production.

Price reforms cannot be discounted. My feeling is, the

price reforms have probably been at least as important as the contract responsibility system. The Chinese continue to rejigger prices, and they've seen just tremendous shifts in resources out of certain products and into other agricultural products, in very short order, with changes in prices.

Senator Proxmire. One of the most interesting contrasts between our country and the Soviet Union, and I presume, China, too, although it would be interesting to get your figures on this, is the enormous proportion of the Russian population that is in agriculture compared to this country.

Now the figures that I had a few years ago were that this country, less than 3 percent of our people were in agriculture, that is, were on farms producing, working on farms as their principal occupation, whereas, in Russia, it's closer to 30 percent, or was.

On China, I don't have any figures at all.

Could you bring me up-to-date on Russia and also tell me what the proportion of the people in China who are involved in food production is, that is, who are on farms?

Perhaps 20 to 25 percent, I believe, of the labor force is now working in agriculture. It was 30 percent back in 1960.

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Senator Proxmire. So they not only had a better crop year, but there's more productive work?

This is in the Soviet Union.

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Senator Proxmire. That's right. We were told by the CIA a few years ago that it was 30 percent. I remember I was so startled by the figure, it remained with me.

[redacted] I believe that figure for 30 percent refers back to 1965 and the 1970s. They've made considerable progress in reducing the labor force in agriculture through the late '70s, they've made less progress since then.

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Senator Proxmire. So it's about 20 to 25 percent now?

[redacted] Of the labor force working in agriculture.

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Senator Proxmire. How about China?

[redacted] 80 percent of China's population is in the rural economy.

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Senator Proxmire. 80 percent?

Mr. [redacted] 80 percent. 800 million people in the countryside. Some experts estimate that as much as 70 percent-- this is the highest estimate--of this rural labor force is surplus labor, you could pull them off the farms without hurting production.

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Senator Proxmire. What you're telling me is that you have about 80 percent of the people in rural areas, and they've mostly engaged in agriculture.

Mr [redacted] At one time of the year or another.

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Senator Proxmire. But about 70 percent of that 80 percent, or 56 percent of the population, to get a precise calculation, is surplus?

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[redacted] That's the high figure, and as I say, it's a very rough figure, but I think it gives you an order of magnitude as to the size of the problem and to the potential if you could put those people into productive employment. The Chinese themselves say that by the year 2000 they hope to have this figure down to about 30 percent. Their goal is to have 30 percent or less of the labor force engaged in agricultural production.

Senator Proxmire. A big share of them are going to be unemployed.

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[redacted] That won't take place. They're basically unemployed now, but they continue to receive a salary and are not unemployed in the Western sense of the word. China will not permit a large amount of Western style unemployment.

Senator Proxmire. Think how many people that is. That's between 500 million and 600 million people.

[redacted] Actually the figure is not that large because much of the rural population is too young or too old to be employed. Nevertheless there is a tremendous amount of surplus labor. All Beijing has to do is give many of these rural people the sign, ie allow them to go into the city and set up barber shops, clothing stands etcetera, and you immediately get an influx. They're already facing problems this way. Their system is not geared to having people move freely from point A to point B. As a matter of fact, it's geared to preventing people from

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moving from rural areas to urban areas. The government is trying to make changes right now that will allow part of this labor force, not to move to Shanghai and Beijing, but to move to small towns that they hope will form in the middle of these green belts.

Senator Proxmire. You mentioned the large and rising budget deficits starting in 1977, which forced cutbacks in investment and transportation.

What had been the trends in other areas of capital investment and what are the causes of those budget deficits

That should be '79. I beg your pardon.

[redacted] '79 was their largest deficit. In '79 and '80 they had sizable deficits. The initial reaction to the deficits was to cut back government spending. At the same time they counseled their industrial sector to also cut back investment. They achieved the cutbacks in government spending, which came mainly out of major infrastructure projects. But in the private sector, what we would have to call the noncontrolled sector, there were big increases in investments.

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Basically, there are several reasons for the deficits. Probably the most important is that when China adjusted prices, they raised procurement prices, meaning the state paid the farmer more, but continued to sell the grain to cities for exactly the same price that they did before. Of course this led to a tremendous subsidy.

Another factor was the readjustment in policy which shifted resources away from heavy industry to light industry. Heavy industry generated a large part of China's tax base, and when production began to slow down, and even decline, tax revenues fell. They had their expenditures going up at the same time their tax revenues were tapering off.

Senator Proxmire. You indicated in your longer statement that Chinese do not reveal much about their defense spending.

Is it roughly as difficult to know what they spend, as it is to know what the Soviets spend? If so, doesn't that mean we know less about the Chinese military, in view of the fact that we place far less emphasis on gathering and assessing information about China's defense?

Mr. Gates. I think that based on [redacted] earlier comments, we do have even greater uncertainties in the realm of Chinese defense spending than we do for the Soviet Union. By the same token, again, I would go back to comments I made earlier. Even so, we have a pretty good fix on the actual military capabilities of the Chinese, in terms of the forces that they have, the equipment that they have, their military research and development, the programs, the new weapons systems that they're developing, whether they're submarines or missiles, and so on.

Senator Proxmire. How about their strategic capability?

Mr. Gates. I would say that our capability there is probably the best of all.

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Senator Proxmire. What's that?

Mr. Gates. I would say that our ability to accurately assess their strategic capabilities is probably the best of any aspect of their military.

Would you like to add anything?

[redacted] I think that's accurate.

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As Mr. Gates said, we basically have a good feel for the direction, for the kind of sacrifice that the military has so far been willing to accept in the name of economic modernization.

Senator Proxmire. How does the Chinese strategic capability compare with the United States and the Soviet Union? Factor of 10? Factor of 20? And with France and the United Kingdom?

[redacted] I would say we should field that question and bring it back. Our military experts aren't here. My own feeling is that they're just not even in the same ballpark as the U.S. or the USSR, especially if you're talking about strategic weapons.

Senator Proxmire. I realize that. I realize they're not in the same ballpark as the United States and the Soviet Union, but I just wondered what the discrepancy is. Is it on the order of, as I say, 10? 20?

Mr. Gates. You're looking at a country where their strategic missiles can be counted in a few 10s.

Senator Proxmire. Compared with a few thousands?

[redacted] Their ships, we could add, are basically coastal ships. They are not a blue water navy.

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Senator Proxmire. And their submarine fleet? Do they have nuclear weapons on their submarines? How about their air force? Does that have a nuclear capability?

[redacted] Again, we should really bring the military people in to talk to you more closely on that.

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Senator Proxmire. You're going to give some of that for the record?

Mr. Gates. We'll respond.

Senator Proxmire. Let me just pursue that question I asked a little bit earlier, just one more time. Maybe you can't give it to me directly, but it would be very helpful if you could make an approximation.

In a discussion of the Chinese defense sector, you indicated that the burden of defense has been reduced somewhat. I realize that you have no precise estimates of the proportion of GNP that goes for defense, but can you say whether it is closer to the US figure of 7 percent, or the Russian figure of 13 to 14 percent?

[redacted] My gut feel is that it would be much closer to the U.S. figure, and when I respond, I will be more accurate.

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Let me say this: there's been a lot of fat in the Chinese military budget that's been cut out without really deleting too much of their military capability, as small as it is.

For example, they had a tremendous capital construction corps. That was part of their military budget. When they cut that military budget, that corps of people was freed up and sent

back to private practice. China's military capability, however, was probably not severely hurt.

So our military people tell me that while the Chinese military has definitely sacrificed, we should not overstate the degree to which it has impacted on military capabilities.

The military continues to get a lot of technology. They have gotten into the business themselves of exporting military weapons, and this has been generating foreign exchange for them.

Senator Proxmire. The last page of your longer statement, you have a table showing selected economic indicators in China. You have the growth of the GNP and the gross value of industrial output, and so forth.

Can you tell me what their GNP is?

[redacted] Well, we do rough estimations of GNP on an annual basis, and have it in the neighborhood of \$300 billion.

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Senator Proxmire. It used to be about the same size as Italy's. Can you give me any countries that are about the same GNP as China?

[redacted] Not right offhand. Again, I can put that in for you.

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[redacted] Mr. Chairman, if I may add, you're correct, in 1983 total Italian GNP in 1983 in U.S. dollars was \$355 billion.

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COMPARING CHINA'S GNP WITH MAJOR OECD COUNTRIES  
(billion US \$)

United States	3305
Japan	1156
West Germany	655
France	543*
United Kingdom	460
Italy	350
Canada	317
China	275
Spain	156

\*1982 figure.

Senator Proxmire. It's a little bigger now. Of course, they have grown more rapidly than just about any other major country, in GNP.

I notice you have a 7.0, 5.2, 3.0, 7.4, 9.0, 10. Those are very, very healthy growth figures.

[redacted] Again, I don't think that's necessarily a good sign. The Chinese are not necessarily pleased at that. As we said in the paper.

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Senator Proxmire. Why?

[redacted] Their feeling is that what they really need is an improvement in efficiency. They continue to produce a lot of junk, basically, and the state continues to have a procure that stuff at high cost. Their warehouses are full and yet their

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factories are crying for better machinery, equipment, and steel.

So what China wanted was growth rates more in the neighborhood of four -- well, their plans have been for anywhere between 4 and 6 percent growth. That's what they were asking for.

Senator Proxmire. Well, that's a good helpful modification.

Your discussion of the problems of inefficiency and waste in the industrial sector suggests recent reports of Chinese economic success may be somewhat exaggerated. Do you agree that a big question mark remains as to whether China will overcome its economic problems and be able to maintain the pace of economic reform?

[redacted] That certainly is a key question. The press is STAT overplaying how well the Chinese have done. The Chinese themselves have been very, very pragmatic, for probably the first time.

Senator Proxmire. Are you talking about our press?

[redacted] Our press, the Western press. STAT

The Chinese themselves have been very, very pragmatic in saying: "We have done well in agriculture, but in the industrial sector, our performance has been bad." They recognize the weaknessess. Party members, for the first time are being told to prepare for problems that will inevitabley arise when reforms go into place. And to attack new problems not by labeling people as capitalists or something else but by trying new reform.

Senator Proxmire. I think that's pretty hard to avoid. We

have an understandable, and, I think, a proper, bias in favor of free enterprise. I am sure all of you would agree with that.

So when they move toward a little freedom, we say, "See how well they're doing?" and we would like to feed on that as evidence of how superior our system is.

It is superior. But, I think we tend to overstate it.

We should probably also say that in terms of the free enterprise, we feel that probably about 2 percent of the Chinese labor force, urban labor force, right now is engaged in these kind of what you could really call free-enterprise--type of activities: small shops, etcetera. So, the sector of the economy that is uncontrolled is still quite small.

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Senator Proxmire. You explained that very well. You point out that the improvements have been by giving incentives to cooperative entities which are not free, competitive operations. And then a price modification, rather than the fact that you have as you say, a lot of people getting into barber shops and that kind of thing, which is fine, but it can't account for the improvement.

An example of the problems that remain in the background, some panic buying, you report, occurred last month in the -- and the fact that you conclude that panic buying would be inflationary in the short run.

Can you give us an idea of the magnitude of these problems, whether panic buying has stopped, and inflation? And I would also

like to discuss the problem of unemployment.

[redacted] The feeling we have is that there were pockets of panic buying and bank runs but the Chinese were quick to stamp these out. They simply refused to let people pull their money out of banks, they also came out strongly with proclamations that no one would be allowed to change prices for a while, and when changes were made they would be gradually with incomes being adjusted at the same time.

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So I think so far the scale of this sort of thing has been very, very small. We highlight it because the potential for major problems is there, and every time the Chinese talk about price reform they raise the spector of bank runs and panic buying.

The Chinese are so sensitive to this that they react quickly whenever problems occur. We are more concerned that they will overreact to this sort of thing than we are that they will let price problems get out of hand.

Senator Proxmire. You warned us about the effect of Deng's death. You also indicated that his successors shared his view of the reforms, or his most immediate successors. But they wouldn't have the same force and power that he has.

Can you give us a little more specific assessment of the prospects for the reform movement to prevail in the event of Deng's death or removal from office in the near future?

[redacted] You know, it's speculation, but I will give you

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my best feel for what could happen.

The two people next to Deng in power are Zhao Ziyang and Hu Yaobang. Both of them are very openly pro-reform. Even the people in the top echelons of the Party who are not strong advocates of reform -- and we do have indications that some important leaders are not fully on board -- are not Maoists. They are not going to argue for a retreat all the way to the left. There are people who would argue that free enterprise should not be allowed to operate to the degree that reformers are now advocating. These opponents argue for a pull back. They contend that free enterprise should operate only at the very fringes, and a tight central plan should regulate the bulk of the economy.

So, whereas during the 1960's and early 1970's we had extremes--Maoists who argued for strict Chinese Marxism opposed to a few others like Deng who were at the other extreme--now the band has narrowed significantly.

Even the people who advocate a retreat from reform are really talking about a retreat to a milder kind of reform. Although this group does not wield much power right now, if the reforms begin to bog down, I think these leaders would resurface, and there's definitely the capability among those people to slow the reform process.

Having said that, the ag reforms have been widely accepted by about 80 percent of the population, and it will be very, very

hard to turn those people around.

So my best guess would be that any new leadership would not be able to undermine the program to a major degree; that, in fact, even when we do get succession, we will continue to have reform.

Again, that's just my guess.

Senator Proxmire. Mr. Gates, would you briefly discuss the recent developments in Chinese-Soviet relations and the prospects for closer ties between them?

Mr. Gates. There were some developments about a year-and-a-half or two years ago that suggested that the two parties, for reasons of their own, probably related to the relationship of each to the United States, was interested in moving closer to one another to establish a closer bilateral relationship.

There were a number of very small steps that were taken, and we anticipated, or at least raised the prospect, that might involve some longer term, significant improvement in relations. Frankly, this just hasn't happened. There has been a slight warming in state-to-state relations. There have been some contacts between the two parties, some negotiations. Trade between the two is increasing rapidly, but from a very small base.

They are still planning on having a Soviet Deputy Prime Minister, or Premier, if you will, visit China, a visit that was cancelled earlier.

But on the whole, it appears that the Soviets are totally

unprepared to meeting the Chinese preconditions for a significantly improved relationship: getting out of Afghanistan, ending their support to the Vietnamese, and getting the Vietnamese out of Kampuchea, getting out of Mongolia, and so on. There's just no sign that the Soviets are prepared to undertake any of those things, and absent that, any improvement in relations, even on a state-to-state basis, will be, in our view, quite limited.

Senator Proxmire. Gentlemen, I want to thank all of you, Mr. Gates, [redacted] and commend you for STAT your excellent testimony and the comprehensiveness and high quality of the papers on the Soviet Union and China.

In the interests of getting information to the public as soon as possible, I would like you to sanitize the written papers you gave us, so they can be released, hopefully in the next two weeks or so.

The entire transcript will eventually be printed in sanitized form, after we have heard from the Defense Intelligence Agency.

Again, I want to thank you and your staff for the fine work you're doing, and your appearance today. Thank you very much.

(Whereupon, at 12:25 p.m., the hearing was adjourned.)